

THE SMITHFIELD Forecast

A Quarterly Survey of Trends • Seventy Third Edition • July 2018

For Customers & Friends of
SMITHFIELD TRUST COMPANY

A NOTE FROM THE CHAIRMAN

We are pleased to send you Michael Drury's latest musings on the economy. He is certainly interesting and, to some extent, contrarian.

I am also taking the liberty to reprint a book review in an earlier Forecast from Hal Haller. The book is "Political Tribes" by Amy Chua, the John M. Duff, Jr. (by wild coincidence, a friend of mine) Professor of Law at Yale. I found Professor Chua's book to be profoundly insightful, and, like Hal Haller, I commend it to you.

— Bob Kopf

HOT ECONOMY

The US economy is running red hot as we start the second half of 2018, but rising interest rates and the trade war are becoming drags on the positive stimulus from tax cuts and spending hikes. We worry that the US and global economy may be nearer the peak of this cycle than is currently built into consensus expectations. Surveys show that few believe the next US recession is likely before 2020 and many don't see a problem until 2021 or beyond. We believe that the benefits of fiscal stimulus, which historically has its greatest effect in the first year, will have run its course by the end of 2018, and that the drag from recent and future interest rate hikes and rising tariffs will hit the economy by mid-2019. That means the 4%+ growth in Q2 should cool to a still robust 3.5% in the second half, and then slow through 2019. We see few excesses other than debt, so we do not expect a deep recession for the real economy like in 2008. Rather, the US could experience a stall, like in 2000 when the technology boom evaporated after Y2K. However as in 2000, the consequences for global equity markets and currencies – especially in Europe and Japan -- could be more significant.

A strong rebound in the second quarter from the soft 2.2% GDP growth in Q1 should lift the first half of 2018 to over 3%, matching the growth rate during the final three quarters of 2017. Under President Trump's pro-business agenda of deregulation, lower taxes and larger fiscal deficits, business and consumer confidence have surged,

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producing growth well in excess of the estimated 2% potential. Durable goods manufacturers, construction and natural resources have benefitted from a moderate pick up in capital spending, helping create about 200,000 jobs per month. The unemployment rate has fallen to near record lows at 3.8%, but still modest productivity growth will limit the upside for the expansion as we run out of bodies. Meanwhile, inflation remains in check as credit demand has been tempered by the Federal Reserve – which has been ahead of the curve for the first time in post-war economic cycles, raising interest rates seven times since December 2015.

Strong economic growth has raised the cost of labor, energy and credit offsetting part of the tax cut on profits. It has also empowered the Trump Administration to pursue its tough trade agenda against NAFTA, China, and now the European Union. To put the tariff war in perspective, note that the Supreme Court just ruled states can collect taxes on products sold online. That could lift sales taxes \$13 billion – about the same as the 25% tariff on \$50 billion of Chinese goods. A 0.25% Federal Reserve rate hike hitting \$5 trillion in short term debt would have the same impact as well. On the flip side, if oil prices fell just \$1 the savings for the US or China (both import roughly 8 million barrels a day) would be about \$3 billion a year. That would almost offset the 25% tariff on \$14 billion for soybeans to China – or a 20% tariff on 500,000 German cars exported to the US.

Many of these numbers sound big – and they are for specific industries. Yet, in a \$20 trillion US economy, \$18 trillion for the EU and \$14 trillion for China, they are manageable. The US should increase oil output by 1 million barrels a day this year – that \$24 billion gain in GDP exceeds the entire \$21 billion in US agricultural exports to China. Moreover, just a 0.1% change in value of the dollar changes the US's global buying power by \$20 billion. For us this math implies that trade issues will continue – and

perhaps escalate -- as the pain they have caused for specific industries is not yet enough to offset the benefit fueled by tax cuts and spending hikes. It will take a major signal like a 10% correction in the equities market or a collapse in President Trump's currently strong polling data to alter the current strategy. The mid-term elections will be a referendum on the Administration's trade and immigration policies, causing either acceleration or a significant reversal. Current polls show slightly better than 50-50 odds that the Republicans retain control of the House.

For US firms, the uncertainty caused by the tariff war is an offset to stimulus from the tax cuts. For their competitors in the rest of the world, it imposes a direct cost – which is compounding their difficulty in adjusting to rising US interest rates. Currencies in a wide swath of Emerging Markets are falling due to dollar debt exposure, supply chain disruptions or sanctions -- all caused by US policies. China was already in a self-imposed economic slowdown to control runaway debt, and now its currency is under pressure reducing the buying power of the world's largest importer of commodities. Other major Asian exporters are losing markets as the EM and China cool. German exporters are facing a perfect storm from a domestic threat to Merkel's leadership, growing EU risk from Italian politics and debt, a cooling in Asian demand and now tariffs on cars headed to the US. As the US economy should remain strong through early 2019, foreign economies will continue to suffer. However, as they have high debt levels and near zero interest rates already, neither monetary nor fiscal policy can forestall economic weakness. Weaker currencies will bear most of that burden.

Uncertainty breeds caution, and forecasters' crystal balls are currently cloudier than ever – as this particular policy mix is unique in the post-war period. Stimulus at the peak of an economic cycle is new. Tariffs haven't been used broadly since Smoot-Hawley in 1930. Econometric models, which rely on historical patterns to project the future,

are ineffective. Political analysis has deteriorated to trying to guess President Trump's next mood. We feel his unexpected successes in passing large tax cuts and spending hikes have fueled a steep surge in growth – which will be followed by an earlier than expected descent. The next round of US stimulus is most likely to come from imported deflation as foreign currencies weaken – allowing the Federal Reserve to pause on raising rates further. Rates that are still relatively low should cushion the correction in housing, autos and other volatile sectors domestically. However, weaker global currencies could hit foreign earnings as they did in 2015. We anticipate the next several quarters will look more like the boom into late 1999, followed by weakness, especially for financial markets, in 2000. Our crystal ball assumes the trade war remains tempered, but we will keep a sharp eye on financial markets and elections – both here and abroad -- as guideposts for a change in the economic path.

— Michael Drury

SMITHFIELD TRUST COMPANY BOOK REVIEWS

MUNICH

By: Robert Harris

I would recommend this book to any fan of historical fiction. The setting is September 1938; Hitler is poised to invade the Sudetenland and British Prime Minister Neville Chamberlain is preparing to go to Munich to meet with the big four European leaders in an attempt to avert war. A central character is Paul von Hartmann, a hypothetical German in the foreign service who is part of a small group of anti-Hitler conspirators who believe that if Hitler takes Germany into war the army will act to remove him, fearing that Germany cannot defeat the allied powers. Von Hartmann has information that he believes will dissuade Chamberlain from entering into an agreement with Hitler. In order to get this information into the Prime Minister's hands, he will rely on Hugh Legat, an old friend from his days at Oxford, who is now in the British diplomatic corps.

The book is a wealth of information on the thinking that motivated both Hitler and Chamberlain, as well as Italy's Mussolini and France's Daladier. In addition, it holds the reader's attention because it reads like a spy thriller.

— Henry Haller, III

POLITICAL TRIBES

By: *Amy Chua*

The internal dynamics in countries can often be understood through consideration of the ethnic and political “tribes” within the country. However, this is largely ignored by our political leaders, according to author Amy Chua, which results in dramatic failures in foreign policy. She explains how this has occurred in Vietnam, in Iraq, in Afghanistan, and in Venezuela. What I found most interesting though was her discussion of the politics in this country, and in particular the surprising victory of Donald Trump in the 2016 Presidential election. Although this took our governing elite by surprise, Ms. Chua explains that a consideration of the “tribe” of white working class Americans makes this outcome quite understandable.

— Henry Haller, III

CARL'S STORY

By: *Noretta Willig*

Poignant, well-written and centered around Pittsburgh, “Carl’s Story” is about Carl H. Willig, born in 1899 in McKeesport, Pennsylvania, and an enlisted soldier in the U. S. Army in World War One. Carl was killed in the woods near St. Mihiel, France, on September 16, 1918, and his remains could not be found. Carl’s death proved to be agonizing for his family, and the inability to find his remains only added to the devastation and family dysfunction created by Carl’s loss.

Ninety years after Carl Willig’s death his niece, Noretta Willig, received an unexpected telephone call from a genealogist with the U. S. Army indicating that two French relic hunters, Roger Schneider and his son, accidentally discovered her uncle’s remains in France. Roger Schneider turns his discovery over to a friend, Elizabeth Gozza, who, by incredible coincidence, heads a French organization whose sole mission is to honor the liberators of France. After rigorous analysis Carl’s remains are returned to McKeesport with full and profoundly moving military honors. The respect and dignity accorded our deceased soldiers by the U. S. Army and France are an important and significant component of the book.

The author’s descriptions of the Willig family, their ties to the steel industry and generational traumas brought about by Carl’s death are also wonderfully depicted by the author.

I highly recommend “Carl’s Story” without equivocation, especially for a Pittsburgher. If you are not touched by its serendipitous tale, something is seriously wrong with you.

— Bob Kopf

BENEATH A SCARLET SKY

By: Mark Sullivan

A good friend suggested that I take a break from my usual historical tomes to try a novel based on true events. So I read “Beneath A Scarlet Sky.”

This novel features Pino Lella, a teenager in Nazi-occupied Milan, Italy, in 1943. Meeting a beautiful slightly older woman, Anna, outside a bakery in Milan, Pino pesters her for a date, but Anna fails to show up for the date. Anna, of course, surfaces later in the story.

When an Allied bomb destroys his home in Milan, Pino’s parents send him to Casa Alpina in northern Italy, where Pino helps a priest transport Jews to safety in neutral Switzerland. Despite lacking any sympathy for the German occupiers, Lella then becomes a chauffeur for General Hans Leyers, a high-ranking Nazi in Italy. Pino also becomes a spy for the Allied cause.

The novel has some interesting twists and turns (especially regarding General Leyers, who is evil but has some fascinating dimensions) and is, for the most part, fast-paced. Having said that, I still prefer what my wife calls my “boring” historical biographies. I liked the book but did not love it.

— Bob Kopf

AN UNLIKELY TRUST

By: Gerard Helferich

Jennifer Trotter of Smithfield’s Operations Center and I share a love of history, and she loaned me “An Unlikely Trust”, featuring her hero, the trust busting Teddy Roosevelt, and his improbable, if somewhat uneasy, collaborations with J. P. Morgan, the most powerful capitalist at the beginning of the twentieth century.

Over time, despite their rhetorical clashes between the need for the dissolution of trusts (Roosevelt) and the need for business consolidations (Morgan), Roosevelt and Morgan cooperated to settle a stifling coal mining strike and the extinguishing of the Panic of 1907. Roosevelt, trusting Morgan, came to regard Morgan’s business combinations like U. S. Steel as “good,” while attacking other combinations. (Roosevelt’s subjective approach in deciding what business combinations to pursue did expose him to considerable criticism at the end of his presidency.) The interactions between the two men are captured by the author in an engaging and readable manner in a short and snappy book.

— Bob Kopf

GIBRALTAR: THE GREATEST SIEGE IN BRITISH HISTORY

By: Roy and Lesley Adkins

Lasting an incredible three years and seven months, the Spanish (and, to a lesser extent, the French) siege of British-held Gibraltar at the end of the eighteenth century diverted precious British resources away from the fight against us in the Revolutionary War. It can be argued that the siege of Gibraltar led to the defeat of the British in the colonies.

The authors tell the story of the siege from a predominantly British perspective, and the courage and the spirit of the civilian inhabitants and soldiers subject to the siege are indisputable. Hunger, typhus, smallpox and seemingly incessant Spanish bombardment were an omnipresent part of this conflict. The ultimate and unexpected collapse of the Spanish and French effort to take Gibraltar is inspiring. One word of warning: since the book describes a slow-moving siege, it can be ponderous at times. Simply remember that this was, after all, a siege.

— Bob Kopf